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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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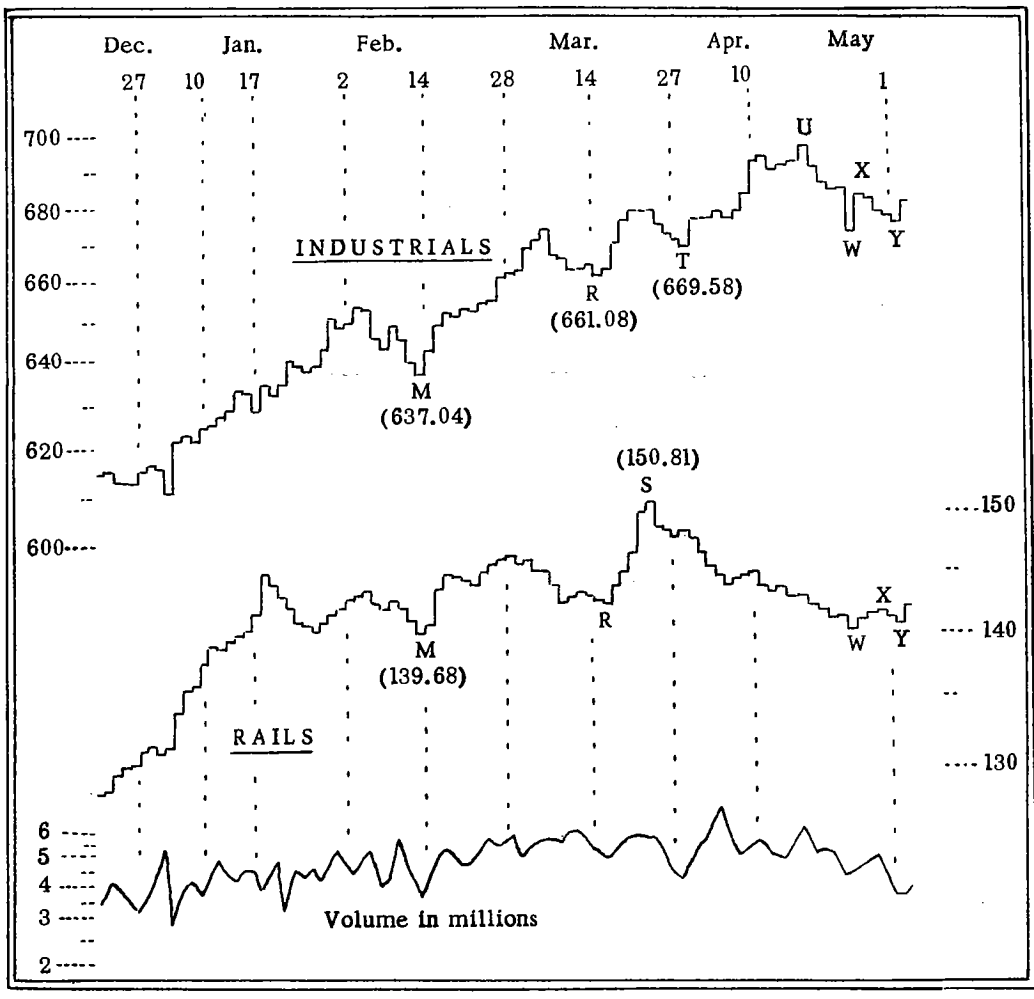
THE MARKET Following its peak at S (150.81), the Rail Average began a long shallow decline which by April 24 saw that Average retreat to within 36¢ (W) of its previous low at M (139.68). During this retreat Rails were subject to almost daily reports concerning dismal earnings (or losses) and lagging carloadings. While the whole story may not yet have been told, it is nevertheless impressive to see the Rail Average hold above M in the face of the barrage of adverse news.

The ability of the Rails (so far) to hold above the important preceding low at M is more impressive than might appear on the face of it. In 1959 the D-J Rail Average earned a total of $11.11; in 1960 that Average's earnings dropped to $6.71. The dividend payout on the Rail Average (based on 1960) amounts to $8.08. The Rails are now paying out considerably more than they are earning. This means that over the foreseeable future Rails must either (1) cut dividends or (2) sustain a marked pickup in earnings.

To put it another way, the D-J Rail Average sold at a peak price of 181.23 in 1956. With earnings off 65% from 1956, the Rail Average is now selling only 22% under its 1956 price. The Rail stocks are heavily leveraged (with debt), and increases or decreases in carloadings can set off wide swings in earning power. Obviously, either Rails are drastically overpriced at this time or they are discounting an important rise in carloadings and earnings. As things stand, a persistent refusal by Rails to violate M should mean that better things are in store for Rails and the economy.



As far as Industrials are concerned, the advance which began at 566.05 on October 24, 1960, reached at least a temporary peak on April 17,

1961, at 696.72 (U). In the five days following U the Industrials lost 24.09 points, retreating to a low of 672.66 (W). Considering the entire 130 point rise since last October, the retreat from U to W amounted to a correction of 18.4%.

The sixty-five year record of the Dow Jones Averages shows that all extended bull market advances have eventually been followed by major corrections or secondary reactions. These reactions tend to retrace 1/3 to 2/3 of the preceding advance while lasting approximately three weeks to three months. With this definition in mind, it is obvious that the U-W decline cannot qualify as a secondary reaction.

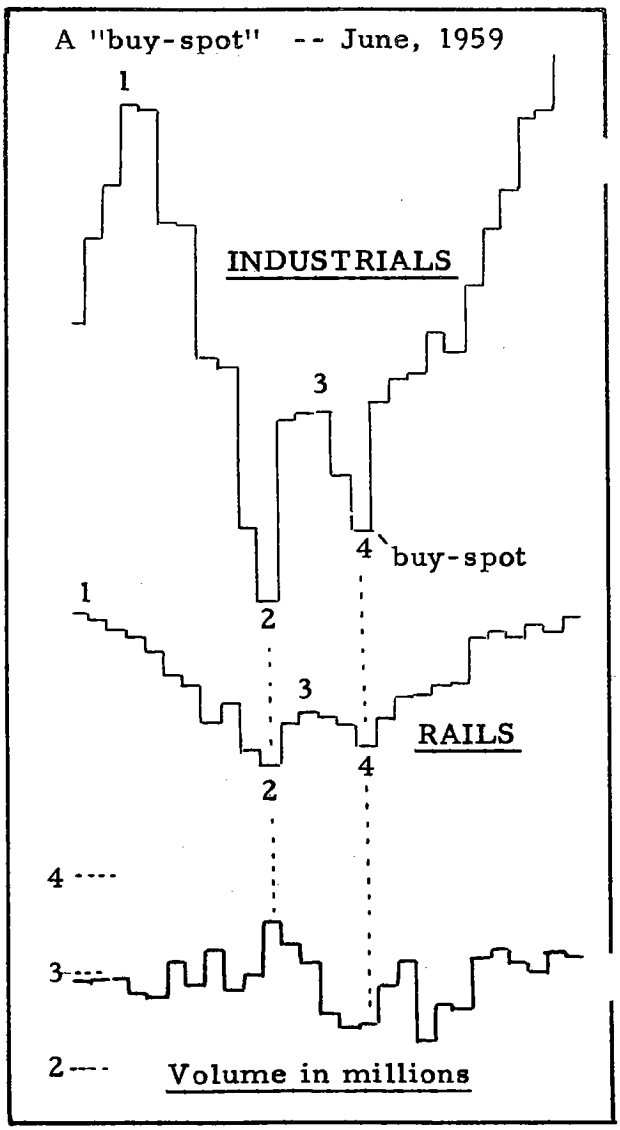
It is also well to remember that the safest and most advantageous buying is generally done at or near important reaction bottoms. The instances in history where one could profitably have bought stocks following an uncorrected 130 point Industrial advance are few and far between. In view of this the question arises -- were purchases warranted at the Y lows?

The last few Letters drew particular attention to T (669.58), the first significant preceding decline point in the Industrial Average, and M (139.68), the low point of the entire Rail structure which has formed since January, 1961. It was stated that as long as one or both Averages held above those points, the secondary trend would remain bullish. In fact, Letter 141 commented: "Regardless of further Rail weakness, if Industrials can hold above T (as volume dries up) the implication will be that another advance is in the offing."

The Rail decline which began at S lasted over four weeks. The Industrial decline which started at U lasted about two weeks. At W Industrials stopped 3.08 points above T while Rails halted 36¢ above M. The decline to W must be considered a "test" of the preceding lows. A minor rally followed this first test, and on the second decline (to Y) the low points again held as volume dropped to 3.71 million shares (the smallest volume in eleven weeks). On a cold reading of the Averages, the action of the market at the Y points suggests that speculative purchases were in order.

Older readers know that the U-W-X-Y formation (see chart) had the appearance of a "buy-spot". There was the initial decline to W, the rally to X, and the second decline (X-Y) which approached, but did not violate W (as volume decreased sharply). When such formations appear the odds are perhaps three to one that they will be followed by higher prices. As mentioned previously, the only argument against the buy-spot at Y is that it occurred so near the preceding highs.

Back in Letter 93 I published a chart which illustrated the typical buy-spot as described by



Robert Rhea. That chart is reproduced in this Letter. Note the rally from point 2 to 3, the decline from 3 to 4 on lower volume (the lower volume is essential), and the sharp rally subsequent to point 4.

Referring to the current U-W-X-Y structure, had this pattern occurred following a normal 1/3 to 2/3 correction, I would have said without hesitation -- "load up". As it is, traders who take positions here will have to cross their fingers and hope that the rally from Y will take the Averages to or above the 1961 highs. Stocks bought here (and those bought at Y) should be purchased with the mental reservation that they will be sold if another decline succeeds in taking Industrials below T and Rails below M.

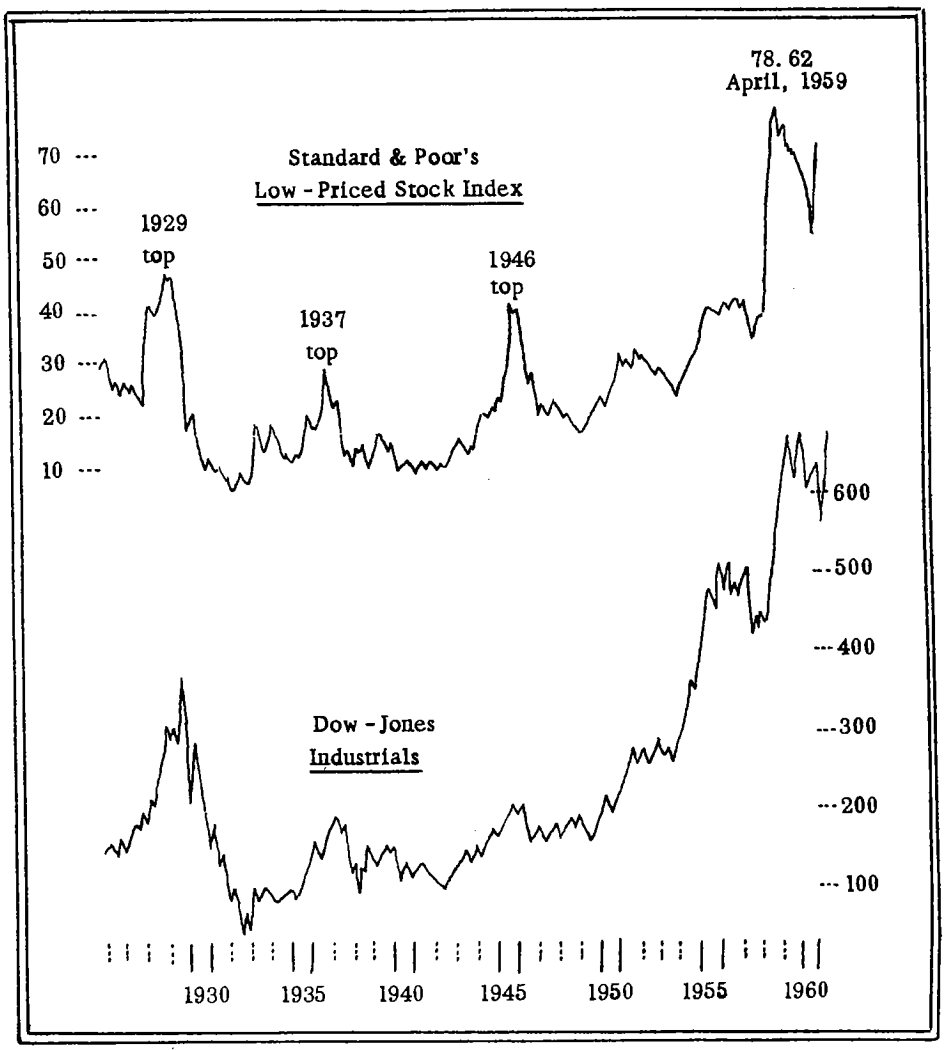
On May 2, following the buy-spot, Rails rallied 1.34 points and Industrials rebounded 5.29. The movement takes the Rail Average above X and forms an upward zig-zag. The stage should be set for an advance and more particularly a rail advance. If rails cannot rally impressively from the present structure -- then (as the Prince put it) "there is something rotten in Denmark".

LOW-PRICED STOCKS A good deal of interest was aroused by the study of Barron's Low-Priced Stock Index in the last Letter. Back in Letter 128 I published a study of the history of low-priced stock activity, using the oldest available index, which is Standard & Poor's. The accompanying chart brings this entire study up to date.

In April, 1959, S & P's Low-Priced Stock Index "topped" in exactly the same manner as did Barron's. At that time, based on the thirty-five year history of S & P's Index, I took the action to be bearish. Letter 128 summed up the discussion with the comment, "If the L-P Index now (1) rallies strongly, (2) forms a 'double top' or (3) goes to a new high, we will have seen something new in market history.

Those who believe that market analysis can be classified as an exact science should study this chart. Here we see the L-P stocks rallying strongly following a formation which appeared every bit as "toppy" as those which occurred in 1929, 1937 or 1946. Having dropped precipitously during most of 1959 and 1960, S & P's L-P Index has now rallied to within 8.5% of its previous high of 78.62 (April, 1959).

From the standpoint of the market, what does this mean? It means that for the first time in modern history, following a collapse in speculative low-priced stocks, enough enthusiasm was generated so that a second "stilt formation" was immediately added to the previous one. There is no questioning the fact that the recent rise in the L-P Index dwarfed the tiny upward "blip" which occurred during the great bear market rally of 1930 (see chart). It is



also significant that the A-D ratio rose impressively during the 1960-61 advance, while during 1930 it hardly budged upward. When I stated that the odds favored this being a primary bull movement, the two factors of low-priced stock activity and rising breadth were definitely considered.

VALUES A subscriber writes to ask me why I am not more "enthusiastic" about the current market, and why I have not recommended "wholesale buying". I will attempt to answer the question.

The time-honored yardstick used by Dow and Hamilton and many of the classicists" has now fallen into disrepute. The concept of values has ceased to be taken seriously on Wall Street or anywhere else. Bethlehem Steel earned 14¢ in the first quarter and is now selling for $48.00. What is it worth? What is it worth if it earns 60¢ in the second quarter? I'm sure I don't know. So what does one do, one pulls out a chart of BS and attempts to determine whether the stock is in a bullish or bearish formation. And although the chart technique is far from infallible, what else do we have to go on? By all fundamental approaches, BS is not worth $48.00, but the stock may well go higher.

The general market is on the same footing. Intelligent technicians, men who have actually been right on the majority of turns, are saying that there will be a final speculative top, but that it will occur somewhere ahead. I quote from a well-known Wall Streeter's recent writing: "When all our indexes finally do reach their 'point of no return' we shall shout them from the housetops. In the meantime we shall go on living on borrowed time".

Leading analysts throughout the country believe that prices are high but are going higher. Furthermore, they believe that they will be able to recognize the signs which will identify the "final top". It would not surprise me if they do. But I can name perhaps half a dozen techniques which ALL THE ANALYSTS are now using -- breadth, volume, group momentum, bank credit, odd-lots, short interest, etc. All of these are excellent gauges of the market and all have an excellent historical record.

But because stocks in general have been over-valued for so long, because the "old fashioned fundamentals" have been so discredited, everybody is now turning to the technical approach (both to justify and to predict). I am not saying that the now widely-followed technical approach will not call the next danger area, but I am saying that a market that has gathered the biggest technical following in history could be extremely deceptive.

By all reports and based on odd-lot studies we are to have a final speculative rise during which the professionals will sell stocks back to the odd-lot public. The significant thing at this time is not that the technicians are predicting all this for the future, but that investors have discarded values as a means of justifying current holdings and purchases. Stocks are now being held by "informed" elements because (regardless of present values) they are "going higher". Caveat emptor.

STOCKS If the Rails can start moving, we would then see a good many of the cyclical stocks rise out of their bases. Stocks such as Firestone, General Electric, Westinghouse, General Motors, Southern Railway and Southern Pacific have been laggards and represent a limited risk on the downside compared to the majority of stocks on the board. From the standpoint of chart action, United Aircraft, Distillers Corp.-Seagrams and U.S. Plywood have given "buy" signals.

(Written Wednesday, May 3, 1961 - 1 P.M.)